No. 12080

In the United States Court of Appeals for the Ninth Circuit

BASALT ROCK CO., INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court (R. 148-170) together with the dissenting opinions (R. 170-179) is reported at 10 T.C. 600.

JURISDICTION

This case involves an asserted deficiency in federal excess profits tax for the calendar year 1942. A notice of deficiency in excess profits tax in the amount of $583,003.64 was mailed by the Commissioner to the taxpayer on January 25, 1946. (R. 16-30.) The taxpayer filed a petition for redetermination with the Tax Court on April 22, 1946, under the provisions of Section 272 of the Internal Revenue Code, in which the existence of the deficiency was denied and in which, as amended, an overpayment of $935,575.38 was asserted to have been made. (R. 1, 4-15, 39-42, 45-51.) The decision of

the Tax Court determining a deficiency of $355,342.21 in excess profits tax was entered on August 30, 1948. (R. 193.) The taxpayer filed a petition for review by this Court on September 29, 1948. (R. 194-204.) The jurisdiction of this Court rests on Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Taxpayers which, for income tax purposes, account for income from long term contracts on the completed contract method of accounting were given an election in Section 736 (b) of the Internal Revenue Code to account for such income on the percentage of completion method for excess profits tax purposes.

The question is whether a taxpayer who exercises the election is required to compute such income on this basis for purposes of the excess profits tax imposed by Section 710 (a)(1)(B) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and regulations involved are set forth in the Appendix, *infra*.

STATEMENT

The Tax Court adopted the stipulated facts as its findings of fact. (R. 149.) Those which are material to an understanding of the issue may be summarized as follows:

The taxpayer is a corporation existing under the laws of California. It is engaged in the business of shipbuilding, and manufacturing concrete aggregates, road and fuel oils, and building materials. (R. 149.) In the course of its business, the taxpayer has entered into certain contracts whose performance requires more than 12 months. In accordance with the provisions of applicable Treasury Regulations, the taxpayer ac-

counted for the income from these contracts by the completed contract method of accounting in its income and declared value excess profits tax returns. Its other income was accounted for in accordance with the accrual method of accounting. These methods are also the methods regularly employed by the taxpayer in keeping its books of account. (R. 149-150.)

On or prior to filing its excess profits tax return for 1942, the taxpayer exercised the election provided for in Section 736 (b) to compute its income from long term contracts on the percentage of completion method. The issue in this case is whether, because of this election, the percentage of completion method of accounting is required in the computation of the taxpayer's surtax net income for the purposes of the excess profits tax imposed by Section 710 (a) (1) (B), it being conceded that this method of computation is required for determining the taxpayer's adjusted excess profits net income for the purposes of the alternative excess profits tax imposed by Section 710 (a) (1) (A). The parties have stipulated what are the pertinent figures involved under both methods of accounting. (R. 55-63, 76-79, 150-153.)

The Tax Court, in a decision reviewed by the full court, decided that the interpretation made by the Commissioner and set forth in his Regulations, namely, that the election in Section 736 (b) applies to the computation of corporation surtax net income for the purposes of the tax imposed by Section 710 (a) (1) (B), is correct. (R. 148-170.) Judge Van Fossan wrote a dissenting opinion, in which Judges Arundell, Black, and Johnson concurred. (R. 170-176.) A separate dissenting opinion was written by Judge Kern; Judges Black and Arundell agreed with this dissent also. (R. 176-179.)

SUMMARY OF ARGUMENT

The excess profits tax is the lower of two amounts, i.e., 90 percent of the taxpayer's adjusted excess profits net income (Section 710 (a)(1)(A), Internal Revenue Code) or an amount which, when added to the income tax, equals 80 percent of the corporation surtax net income (Section 710 (a)(1)(B)). In the case of taxpayers, like the present, which derive income from long term contracts and which regularly report such income on a completed contract method of accounting, Congress granted an exception and permitted them, for excess profits tax purposes, to compute long term income on the percentage of completion method.

A taxpayer which exercises the election is required to use the percentage of completion method not only in computing its adjusted excess profits net income for the tax under Section 710 (a)(1)(A), a matter which is conceded, but also in computing its corporation surtax net income for the tax imposed by Section 710 (a)(1)(B). This conclusion is required by the precise terms of the statute, and by the statutory pattern of definitions. The election under Section 736 (b) is for the purposes of the excess profits tax and is made in reference to the computation of income. The same reasons why the election operates in the calculation of income, as translated into adjusted excess profits net income, also apply to the calculation of income which becomes translated into surtax net income. No other conclusion is possible under the statutory terms. The contrary construction, urged by the taxpayer, is one which disregards the exact language which was deliberately chosen by Congress.

The legislative history and the purpose of the statute also confirm the construction which follows from the literal statutory language. Since Congress created the election in order to avoid a distortion in income for

purposes of the excess profits tax, it was never intended that a taxpayer should be using an undistorted income for some excess profits tax purposes and a distorted income for other excess profits tax purposes, as the taxpayer seeks to do. The construction requested by the taxpayer, moreover, in attempting to use two different accounting methods simultaneously, can only give rise to incongruous tax results and would place taxpayers who regularly use the completed contract method on a preferential basis over that of taxpayers similarly situated but who normally use the percentage of completion method.

Finally, since the Commissioner's construction of the statute is embodied in Regulations which were specifically authorized by Congress and since those Regulations, at the least, represent a reasonable and permissive interpretation of the statutes, the Regulations must be upheld.

ARGUMENT

A taxpayer which under Section 736 (b) of the Internal Revenue Code, elects to compute income from long term contracts on the percentage of completion method for excess profits tax purposes must do so consistently for the excess profits tax imposed under Section 710 (a) (1) (B) as well as for the alternative tax under Section 710 (a) (1) (A).

Introductory

The question for decision in this case relates to the proper method of accounting to be employed in calculating the taxpayer's excess profits tax liability for the year 1942. This accounting problem arises out of the following general background:—In addition to the methods of accounting generally available to all taxpayers,[1] those who receive income from long term con-

[1] The cash receipts and disbursements, or, if the taxpayer keeps his books of account in that manner, the accrual methods of accounting generally determine when items become taxable as income, or become deductible; of course, the method of accounting employed must clearly reflect income. See Sections 41-43, Internal Revenue Code; Sections 29.41-1—29.43-2, Treasury Regulations 111.

tracts [2] are specifically permitted by provisions of the Treasury Regulations to calculate their gross income from these sources on either the completed contract or on the percentage of completion methods of accounting. Section 29.42-4, Treasury Regulations 111, Appendix, *infra*.[3] As those terms imply, the long term method is one where the income from such a contract is reported only in the year when the contract is completed and the work accepted. Under the percentage of completion method, however, the income is reported in accordance with the progression of the work. Neither method, of course, bears any necessary relationship to the time when the taxpayer receives the income.

In making amendments to the excess profits tax law [4] in 1942, it appeared to Congress, for reasons which will be amplified later, that the excess profits tax might operate unfairly to some taxpayers who, for income tax purposes, regularly report their income on a completed contract basis. Accordingly, Section 736 (b) (Appendix, *infra*) was added to the Code [5] to provide that, for excess profits tax purposes, a taxpayer could elect to compute "income" from long term contracts upon the percentage of completion method. The election, however, did not require or permit the taxpayer to change from the completed contract

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[2] This term is defined by Section 29.42-4, Treasury Regulations 111, as meaning building and construction contracts covering a period of more than one year from the execution to the completion of the contract.

[3] Provisions permitting the use of these methods in accounting for income from long term contracts first appeared in Article 121, Treasury Regulations 33, promulgated under the Revenue Act of 1916.

[4] The tax on excess profits, for taxable years beginning after December 31, 1945, was repealed by Section 122 (a), Revenue Act of 1945, c. 454, 59 Stat. 556.

[5] Section 736 was added to the Internal Revenue Code by Section 222 (d) of the Revenue Act of 1942, c. 619, 56 Stat. 798.

method of accounting in calculating its income for purposes of Chapter 1 of the Code, which imposes a tax on normal tax net income (Sections 13 and 14 (Appendix, *infra*)) and a surtax on corporation surtax net income (Section 15 (Appendix, *infra*)).

The measure of the excess profits tax imposed by Chapter 2 during the taxable year was either 90 percent[6] of the "adjusted excess profits net income" (Section 710 (a)(1)(A) (Appendix, *infra*), or an amount which, when added to the "tax imposed for the taxable year under Chapter 1", equalled "80 per centum of the corporation surtax net income, computed under Section 15" (Section 710 (a)(1)(B) (Appendix, *infra*)). The lower of the amounts calculated either under Section 710 (a)(1)(A) or Section 710 (a)(1)(B) determined the excess-profits tax liability.

The controversy here centers on Section 710 (a)(1)(B), the taxpayer contending that despite its having elected under Section 736 (b), for excess profits tax purposes, to compute income from long term contracts on the percentage of completion method, the measure of its surtax net income for purposes of applying Section 710 (a)(1)(B) is determined by accounting for its income from long term contracts on the completed contract basis, and not on the percentage of completion basis.

The Commissioner's view is that when a taxpayer elects under Section 736 (b) to account for income from long term contracts on the percentage of completion method, the election requires consistent income accounting on this basis for all purposes where the imposition of the excess profits tax requires the determination of the taxpayer's income, and that this method of accounting is as much required in Section 710 (a)

[6] Section 202 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21, increased this rate to 95 percent.

(1)(B) as it is in Section 710 (a)(1)(A). It is this view which has been adopted by the Tax Court, and which is embodied in Section 35.736 (b)-3, Treasury Regulations 112 (Appendix, *infra*), as follows:

> The excess profits tax may be computed under section 710(a)(1)(B) as an amount which when added to the normal tax and surtax computed under Chapter 1 for the taxable year equals 80 per cent of the corporation surtax net income properly adjusted under the provisions of section 710(a)(1)(B) applicable to such year. For such purpose, the corporation surtax net income shall be determined by computing the income from long-term contracts upon the percentage of completion method of accounting. * * *

It is not denied that the above quoted portion of the Regulations, if valid, governs the issue of this case. The taxpayer, to overturn the Tax Court's decision as one which is clearly erroneous, must establish that the statutory meaning is so clear and unambiguous that there is no room for interpretation, and that the Commissioner's Regulations are invalid because they are clearly opposed to the will of Congress. If, however, as the Commissioner contends, this provision of the Regulations embodies the correct interpretation of the statute, or even if it embodies a permissive interpretation, it is clear that the decision below must be affirmed.

The tax on corporate excess profits was added to the Code by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974. Until 1942,[7] the rate of tax was progressive, but did not rise above 60 percent of the adjusted excess profits net income. The Revenue Act of 1942, the first major revenue legislation to be enacted

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[7] The rate of tax was slightly altered by Section 201 (a) of the Revenue Act of 1941, c. 412, 55 Stat. 687.

after the entry of the United States into the war, made drastic revisions in the excess profits tax. Since the statutory provisions in question were adopted in that Act, we turn to examine their legislative origins.

As reported to the House, the Revenue Bill of 1942 proposed important changes in the then provisions of the excess profits tax law. It was recommended that a flat rate of 87½ percent be imposed on adjusted excess profits net income, in lieu of the then progressive rate structure which ranged from 35 to 60 percent. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 19 (1942-2 Cum. Bull. 372, 389). In so doing, however, the House Committee on Ways and Means recognized that reasonable precaution would have to be taken to avoid unfair application of the tax in abnormal cases, and (H. Rep. No. 2333, *supra,* p. 21) "that high rates on excess profits are thoroughly justifiable if the income subject to tax is clearly of the type intended to be reached." Accordingly, certain general relief provisions were recommended; in addition, specific relief was proposed in the case of taxpayers who reported income on the installment basis.

This section of the Bill, which, as enacted, became Section 736 (a) of the Code, was explained by the House Committee in the following terms.—Taxpayers using the installment method of accounting report the income in the year in which payments are received, while expenses relating to such sales are deducted in the year in which the sales are made. Because of newly imposed credit restrictions, and with taxpayers shifting to war contracts, the Committee pointed out (p. 26) "there is a bunching of income in the taxable year without the normal installment selling costs to reduce such income." Accordingly, for taxpayers who could show that their installment credit in the prior four years exceeded 125 percent of that extended in the taxable year, the Com-

mittee proposed that they be permitted to elect (p. 26) "only for excess profits tax purposes" to report such income on the accrual basis. The Committee also said (p. 150) that "for excess profits tax purposes" the election would enable a taxpayer to compute "its gross income from installment sales on the accrual basis."

The Senate Finance Committee, while proposing certain changes in the House version, also recommended that installment basis taxpayers be given an election to report, for excess profits tax purposes, such income on the accrual basis. It went further, however, and recommended that specific relief be made available to taxpayers who derive income from long term contracts. The Committee stated (S. Rep. No. 1631, 77th Cong., 2d Sess., p. 208 (1942-2 Cum. Bull. 504, 657)):

> Such income is bunched in the year in which it is reported and unless it is spread out over the period of the contract under which the work has been performed a distorted picture of the taxpayer's true earnings for such year is presented. Since only one excess profits credit would be allowed in computing adjusted excess profits net income for such year, whereas several excess profits credits would have been utilized if the income from the contract were returned in the years during which the work was being done, an inordinate excess profits tax would be collected from such taxpayer upon such income. * * *

Accordingly, it recommended the addition of Section 736 (b) to the Code, dealing with income from long term contracts, as a parallel to Section 736 (a), dealing with income from installment sales. As explained by the Committee, a taxpayer who met the eligibility requirements of Section 736 (b) (S. Rep. No. 1631, *supra* (p. 209))—

> may elect for excess profits tax purposes, in accordance with regulations prescribed by the Com-

missioner with the approval of the Secretary, to compute in its return for such taxable year its income from such contracts upon the percentage of completion method of accounting. * * * The net income of the taxpayer for each year prior to that with respect to which such election was made, including the base period years of the taxpayer, shall be adjusted for excess profits tax purposes to conform to this election. * * *

The Senate version of Section 736 was adopted after conference. H. Conference Rep. No. 2586, 77th Cong., 2d Sess., p. 63 (1942-2 Cum. Bull. 701, 721).

Accordingly, Section 736 (b) of the Code, as added by Section 222 (d) of the 1942 Act, provided:

(b) *Election on Long-Term Contracts.*—In the case of any taxpayer computing income from contracts the performance of which requires more than 12 months, if it is abnormal for the taxpayer to derive income of such class, or if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, it may elect, in its return for such taxable year for the purposes of this subchapter, or in the case of a taxable year the return for which was filed prior to the date of the enactment of the Revenue Act of 1942, within 6 months after the date of the enactment of such Act, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting. Such election shall be made in accordance with such regulations and shall be irrevocable when once made and shall apply to all other contracts, past, present, or future, the performance

> of which required or requires more than 12 months. The net income of the taxpayer for each year prior to that with respect to which the election is made shall be adjusted for the purposes of this subchapter, including the computation of excess profits net income in each taxable year of the base period under section 711 (b), to conform to such election but for purposes of chapter 1, the tax imposed by this subchapter for any prior taxable year on account of the adjustment required by this subsection shall be considered a part of the tax imposed by this subchapter for the taxable year in which such income is, without regard to this subsection, includible in gross income. Income described in this subsection shall not be considered abnormal income under section 721.

As passed by the House, the 1942 Bill imposed an excess profits tax at a flat rate 90 percent on the adjusted excess profits net income, a slight increase in rate over that which had been recommended by the House Committee on Ways and Means. The Senate Finance Committee, however, recommended that the total taxes paid by a corporation which are based on income, i.e., normal, surtax, and excess profits taxes, ought not to exceed "80 percent of the corporate profits", saying (S. Rep. No. 1631, *supra* (pp. 29-30)):

> The committee hearings disclosed that in the case of a number of corporations, the combined effective rate of the normal tax, surtax, and excess-profits tax would approach 90 percent. These companies have small excess-profits credits but having expanded tremendously in war work find almost all of their income subject to the 90-percent excess-profits-tax rate. Your committee feels that in no case should more than 80 percent of corporate profits be taken in normal tax, surtax, and excess-profits tax. Consequently, the bill limits the over-all effective rate of these taxes to 80 percent of the surtax net income before its reduction by the credit

for the income subject to excess-profits tax. The effect of this provision is to reduce the excess-profits tax in such cases to an amount which when combined with the normal tax and surtax will not exceed the 80-percent limitation.

The Senate version was accepted and, as amended by Section 202 of the 1942 Act, Section 710 (a) of the Code provided:

> (1) *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:
>
> (A) 90 percentum of the adjusted excess-profits net income, or
>
> (B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter).

A. *The construction urged by the Commissioner and adopted by the Tax Court is required by the literal language of the statutes*

An examination of the precise language of the statute, and the application of the various definitions formulated by Congress make it exceedingly plain that the Regulations express the meaning intended by Congress and that the Tax Court correctly applied the statutory provisions.

Before undertaking a detailed analysis of these statutory provisions, however, we wish to emphasize our conclusion that the taxpayer here is seeking to employ

a certain method of accounting for its income for excess profits tax purposes despite the fact that Congress expressly considered that the use of this method would result in a distortion of income for excess profits tax purposes. That is, the reason for granting the election in Section 736 (b), as explained by the Senate Finance Committee, *supra,* was that, where the eligibility requirements were met, the use of the completed contract method would otherwise result in a "distorted picture" of the taxpayer's "true earnings" for such year and the imposition of an "inordinate excess profits tax." Yet, the taxpayer insists that such a distorted picture of earnings is to be employed in accounting for its income and in measuring its excess profits tax liability under Section 710 (a)(1)(B). We also wish to emphasize that the taxpayer is seeking an interpretation of the statute which, generally, would put taxpayers who regularly report their income on the completed contract basis in a more favorable position because they elect to use the percentage of completion method for excess profits tax purposes than could be enjoyed by taxpayers who regularly use the percentage of completion method. It would be strange, indeed, if Congress had intentionally written the statute to require such bizarre results. As we shall show, precisely the opposite is true.

We also wish to observe, at this conjuncture, that while this taxpayer, during this particular year, acquires a tax advantage in using the completed contract method under Section 710 (a)(1)(B), it is also true that such a method of accounting, if required of other taxpayers who have elected to report income from long term contracts on the percentage of completion method, would result in a decided tax disadvantage to them in particular tax years. Consequently, while Section 736 (b) was intended as a relief provision, it must be

remembered that the construction contended for by the taxpayer will not be liberal to all taxpayers. See fn. 10, *infra.*

By tracing through the pertinent statutory provisions, it will be seen how Congress, with an intended precision, made it manifest that the exercise of the election under Section 736 (b) would require the use of the percentage of completion method not only in the calculation of adjusted excess profits net income in relation to the tax measured under Section 710 (a) (1) (A), but also in the calculation of corporation surtax net income, computed under Section 15, in relation to the tax measured under Section 710 (a) (1) (B). In other words, it will be seen that when it was specified that the election under Section 736 (b) was to be "for the purposes of this subchapter" or, as expressed more conveniently in the Committee Reports, "for excess profits tax purposes", Congress meant precisely that. It did not mean, as the taxpayer would have it, that the election was for some excess profits tax purposes, or only for purposes of Section 710 (a) (1) (A). If there were nothing else, we submit that the phrase "for the purposes of this subchapter" would be a persuasive, if not conclusive, refutation of the construction advocated by the taxpayer.

But we need not stop there. The election in Section 736 (b), it should be emphasized, is in terms of using the percentage of completion method for computing "such income" for excess profits tax purposes. The choice of the word "income" was deliberate and studied. This is manifest from the legislative history of the section.[8] It furnishes a key which will fit into only one

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[8] In the form that it passed the House, Section 736 (a) of the Code, which is parallel to Section 736 (b), spoke in terms of an election to compute "gross income" from installment sales on the accrual basis. The Senate changed the language to read "such income." The Senate Committee's Report, *supra* (p. 208), stated:

place in the statutory pattern, opening a single door which leads not alone into Section 710 (a)(1)(A) but also into Section 710 (a)(1)(B). That place is in the computation of net income under Section 21. (Appendix, *infra*).

We shall demonstrate why this is so. Having made the election under Section 736 (b), it becomes immediately apparent that a taxpayer cannot make a direct statutory transition to even Section 710 (a)(1)(A). That is clear on the face of things because the election under Section 736 (b) is in terms of how to compute "income" while Section 710 (a)(1)(A) imposes the tax on "adjusted excess-profits net income"—two different terms. Since, unless Congress went to much meaningless bother, the election under Section 736 (b) must at least be reflected in the tax imposed by Section 710 (a)(1)(A), it is important to discover how and where the percentage method of accounting for long term contract income will first enter into the computation of the adjusted excess profits net income. To do this, we must turn to the definition sections.

The "adjusted excess-profits net income", upon which the tax is imposed by Section 710 (a), is defined by Section 710 (b) as being the "excess profits net income" less the sum of a specific exemption, the excess profits credit allowed under Section 712, and the unused

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Your committee has provided for the computation of income, rather than gross income, upon the accrual basis in such years. * * *

It drafted Section 736 (b) in the same manner. The use of the word "income" was undoubtedly used synonymously with "net income." See the penultimate sentence of Section 736 (b) which uses the term "net income" in providing for making adjustments for prior years, including the computation of excess profits net income in the base period years. The change from the term "gross income", which had been used in the House version, undoubtedly stemmed from a desire to make it clear that not only should gross income be accounted for under the method elected by the taxpayer, but that items of deductions should be calculated under a consistent system of accounting.

excess profits credit adjustment. The excess profits credit allowed under Section 712 is determined either by average base period income under Section 713, or by invested capital under Section 714. The "excess profits net income" is defined by Section 711 (a) as being the "normal-tax net income, as defined in Section 13 (a)(2), for such year", to which certain adjustments are made—the character and extent of the adjustments being dependent on whether the excess profits credit is computed under Sections 713 or 714. It is readily apparent that none of the credits, adjustments or exemptions in the excess profits tax law affords a basis for the application of Section 736 (b), and for using the percentage of completion method in the final figures which will represent the "adjusted excess profits net income."

Accordingly, if the percentage of completion method is to be employed for purposes of Section 710 (a)(1)(A) it must be given effect in computing "normal-tax net income, as defined in section 13(a)(2)," which is the starting point for determining "adjusted excess-profits net income." Thus, the initial point of reference cannot be located in the excess profits tax provisions, but must be found in the sections of the statute contained in Chapter 1, which uses definitions originally designed for the normal tax and surtax, but which definitions are also used as the stems upon which are built terms used in the excess profits tax law.

The "normal-tax net income" is defined by Section 13(a)(2) (Appendix, *infra*) as "adjusted net income" minus a credit given by Section 26(e) (Appendix, *infra*) for income subject to the excess profits tax. "Adjusted net income" is defined by Section 13(a)(1) (Appendix, *infra*) as "net income" minus a credit given by Section 26(a) relating to interest on certain obligations of the United States. Thus we reach the familiar

term of "net income" which Section 21(a) (Appendix, *infra*) defines as "gross income computed under section 22, less the deductions allowed by section 23."

Retracing this statutory pattern of definitions, it becomes clear that the first point at which the method of accounting for income elected under Section 736 (b) can be given effect is in the computation of net income under Chapter 1, i.e., gross income less deductions. Since the election under Section 736 (b) is in terms of computing "income" or "net income" it seems plain that this was the point at which Congress intended that the income from long term contracts should be accounted for on the percentage of completion method. It is this net income, so computed, which, after all the changes required by Sections 13(a), 710(b), 711, 712, 713, and 714, emerges as the "adjusted excess-profits net income" on which the tax is imposed by Section 710(a)(1)(A).

It will be noted that the foregoing results in two different normal tax net incomes for a taxpayer who exercises the election provided for in Section 736(b). Such a taxpayer will first compute his gross and net incomes by accounting for income from long term contracts on the completed contract method. This will give a certain normal tax net income under Section 13 (a)(2), on which the normal tax is imposed by Section 13 (b). However, to account for such income on the percentage of completion method for excess profits tax purposes (at least for purposes of computing adjusted excess profits net income) the taxpayer must recompute its Chapter 1 net income on this accounting basis, which will give it a different normal tax net income for purposes of the excess profits tax. Only by using this different normal tax net income as the base can the proper accounting method be used in the computation of

the adjusted excess profits net income, and of the excess profits tax imposed by Section 710 (a)(1)(A).

The existence of two such normal tax net incomes, one for purposes of Chapter 1 and one for purposes of the excess profits tax under Chapter 2, was the conclusion of the Tax Court in *West End Furniture Co.* v. *Commissioner,* 6 T. C. 557. The taxpayer there had elected to compute income from installment contracts on the accrual basis under Section 736 (a), the counterpart of Section 736 (b). The issue related to the credit provided by Section 26 (e) which was equal to "adjusted excess-profits net income." The taxpayer contended that since adjusted excess profits net income was defined in terms of normal tax net income, and since its normal tax net income was computed on the installment basis for purposes of Chapter 1, it was entitled to use the installment basis in calculating its adjusted excess profits tax net income for the purposes of the credit in Section 26 (e), even though it calculated its adjusted excess profits net income on the accrual basis for the tax imposed by Section 710 (a)(1)(A). The Tax Court rejected this contention, stating (pp. 563-564):

> Petitioner elected under 736 (a) "to compute its income from installment sales on the basis of the period for which such income is accrued" for excess profits tax purposes, instead of the installment basis which it uses for income tax purposes. For that reason, in its case, when it computed its excess profits tax liability, the normal tax net income referred to in section 711 (a) was a normal tax net income computed on the accrual basis, not the normal tax net income computed on the installment basis on which it paid its income tax. Otherwise, its purported election would be meaningless and ineffective. It is thus impossible to escape the conclusion that the term "normal-tax net income" as used in section 711 (a) does not, in and of itself, and

> in every case, mean the normal tax net income used for income tax purposes. In the case of a taxpayer who has elected to compute his excess profits tax income on an accrual basis, the normal tax net income which is an integral factor in such computation must necessarily be computed also on the accrual basis, in order to give any effect whatever to the election. * * *

We have dealt at some length with the manner in which the election under Section 736 (b) enters into the computation of adjusted excess profits net income and the tax imposed by Section 710 (a)(1)(A). We have done so, however, because essentially the same matters prove the validity of the Commissioner's construction of Section 710 (a)(1)(B), and expose the fallacies on which rests the construction urged by the taxpayer.

The same considerations, it now becomes apparent, are equally applicable to Section 710 (a)(1)(B). Whether Section 710 (a)(1)(B) be regarded as imposing an alternative excess profits tax, or setting a limitation on the amount of the tax, it uses as its measuring reference point "the corporation surtax net income, computed under section 15." It is thus similar to Section 710 (a)(1)(A) which imposes the tax on adjusted excess profits net income but which, as we have seen, uses as its measuring reference point "the normal-tax net income, as defined in section 13 (a)(2)." (See Section 711 (a).) However, "the corporation surtax net income" and the "normal tax net income" are both calculated on the basis of the corporation's "net income" and differ from each other only with respect to the different adjustments to net income required by Sections 13 (a) and 15 (a). Both of them, of course, derive their basic figures from the accounting method which is used in computing gross and net income in the first instance.

Accordingly, since percentage of completion is the proper accounting method employed (once the election is made under Section 736 (b)) in computing the "net income" from which is derived the "normal tax net income, as defined in section 13 (a)(2), for such year," from which is derived the "adjusted excess profits net income" for the tax under Section 710 (a)(1)(A), the same method of accounting is equally required in computing the same "net income," from which is derived the "corporation surtax net income, computed under section 15," and which determines the tax or the limitation on the tax under Section 710 (a)(1)(B).

As we have seen Section 736 (b), in the case of adjusted excess profits net income, requires the computation of two normal tax net incomes, one on the completed contract method for purposes of the normal tax imposed by Chapter 1, and one on the percentage of completion method for excess profits tax purposes under Chapter 2. In the same manner, accordingly, a corporation must have two corporation surtax net incomes, one computed under the completed contract method for purposes of the surtax imposed by Chapter 1, and one computed under the percentage of completion method for purposes of the excess profits tax imposed by Chapter 2. The differences in amount between these two normal tax net incomes and these two corporation surtax net incomes will stem from the fact that two different accounting methods are required in computing net income, i.e., completed contract method for purposes of normal tax and surtax, and percentage of completion method for purposes of the excess profits tax.[9]

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[9] Even where the same method of accounting for income is used, corporation surtax net income, as determined for purposes of Section 710 (a)(1) (B), will always differ from corporation surtax net income as determined for purposes of the surtax imposed by Section 15, for the reason that the latter includes the credit deducted under Section 26 (e) while the former, as specified in Section 710 (a)(1) (B), is computed without the credit provided in Section 26 (e).

B. *The construction urged by the taxpayer does violence to the plain language used by Congress*

The validity of this analysis of the meaning of the statute receives added emphasis when it is compared with the construction urged by the taxpayer. The taxpayer's entire argument is pitched on the ground that Section 710 (a)(1)(B) ultimately imposes the excess profits tax in terms of a percentage of the "corporation surtax net income, computed under section 15," and on the supposition that it has only one such surtax net income, which is to be computed under the completed contract method which it used for purposes of the surtax imposed under Chapter 1. (Br. 25-32, 46-53.) The taxpayer would thus limit the effect of the election under Section 736 (b) to the tax computed under Section 710 (a)(1)(A), contending that the election to use the percentage of completion method of accounting for income relates only to the computation of adjusted excess profits net income. (Br. 50-53.)

This argument, however, places the taxpayer in a decided dilemma from which no escape is possible. The dilemma, of course, lies in the fact that once it is conceded that the percentage of completion method enters into adjusted excess profits net income for purposes of Section 710 (a)(1)(A) because it is the method of accounting, for excess profits tax purposes, to be used in computing normal tax net income under Section 13 (a)(2), the same conclusion is required respecting the

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This difference, however, does not affect the basic matter of what system of accounting is to be used initially in determining net income. Accordingly, for the purposes of discussion in the brief, the difference has been disregarded.

It will be noted that the same difference must also exist between normal tax net income and adjusted excess profits net income. That is, normal tax net income will include the deduction under Section 26 (e) while adjusted excess profits net income is always adjusted to exclude the Section 26 (e) credit. See Section 711 (a)(1)(A) and (2)(C).

computation, for excess profits tax purposes, of corporation surtax net income under Section 15. See Point A, *supra*. The taxpayer attempts to avoid calling attention to this fatal defect in its argument by offering no direct explanation of how the election under Section 736 (b), which is in terms of computing "income" for excess profits tax purposes, becomes translated in terms of "adjusted excess-profits net income," as it must, to become effective under Section 710 (a)(1)(A). But the fallacy of the taxpayer's position is, nontheless, betrayed when it quotes with approval and italicizes (Br. 32) the following sentence from Judge Van Fossan's dissenting opinion below (R. 173):

> Its election [under Section 736 (b)] was made only with reference to the *excess profits net* income. (Italics supplied.)

Judge Van Fossan reiterated the same idea later when he said (R. 175):

> In my opinion, the election under section 736 (b) is applicable to the determination of *excess profits net income* for the purposes of section 710 (a)(1)(A) only and not to the determination of "corporation surtax net income." * * * (Italics supplied.)

Thus, to avoid the plain dilemma, the taxpayer and the dissenting judges below must rewrite the provisions of Section 736 (b) so as to substitute "excess profits net income" where Congress used the word "income."

Congress, of course, could have provided that the election under Section 736 (b) was for the computation of "excess profits net income." This would have had the ultimate effect which the taxpayer is trying to achieve, namely, of limiting the election under Section 736 to the operation of Section 710 (a)(1)(A). But Congress did not do so, either in Section 736 (a) or in Section 736 (b). Instead, it used the word "income"

and, as we have seen, did so deliberately. Also, if Congress had intended to accomplish what the taxpayer now urges, it could have specified that the election was only for purposes of the tax imposed by Section 710 (a)(1)(A). But Congress did not do so, either in Section 736 (a) or in Section 736 (b). Instead, it used the phrase "for the purposes of this subchapter" and, we insist, did so designedly. Finally, if it were necessary to demonstrate that the congressional draftsmen knew how to differentiate between these terms, we might point to the penultimate sentence of Section 736 (b) where the terms "net income," "for the purposes of this subchapter" and "excess profits net income" are used, each with its proper meaning and each for a definite purpose.

Thus, the entire basis of the taxpayer's argument is dependent upon a construction of the statute which is at variance with the legislation as actually written by Congress. When the terms in Section 736 (b), however, are given their plain meaning, they fall into the statutory scheme with ease. They result, as demonstrated in Point A, *supra,* in a taxpayer having two corporation surtax net incomes—one computed under the percentage of completion method for Section 710 (a)(1)(B), just as it has two normal tax net incomes—one computed under the percentage of completion method for translation into adjusted excess profits net income for Section 710 (a)(1)(A).

The taxpayer seems to think that its strained construction is necessary because the bill, as passed by the House, did not contain Section 710 (a)(1)(B), and because the phrase "for the purposes of this subchapter" was used in the House version of Section 736 (a). Therefore, the argument runs, this phrase (Br. 53)—

> could not possibly have referred to the measure of the 80 per cent limitation under section 710 (a)

(1)(B), a section later inserted in the bill by the Senate Finance Committee.

The short answer to this is that Section 710 (a)(1)(B) was added by the Senate at the same time when it added Section 736 (b); when it used the terms "for the purposes of this subchapter" and "such income" in that section, and used the same terms in Section 736 (a), it did so deliberately and intended them to apply not only to Section 710 (a)(1)(A), but to Section 710 (a)(1)(B) as well. The taxpayer is really contending that the Senate did not know what it was doing when it simultaneously added both sections to the statue; there is no possible warrant for such a conclusion.

C. *The construction urged by the taxpayer would frustrate the purpose of Congress*

The construction of the statute urged by the taxpayer, in requiring judicial rewriting of the terms actually used by the legislature, would not only disturb the plain language used by Congress but would frustrate the legislative purpose which prompted the enactment of these sections of the statute.

As we have seen, Section 710 (a)(1)(B) was adopted to prevent the normal, surtax and excess profits taxes, in the agregate, from consuming more than 80 percent of the corporate profits. Section 736 (a) and (b) was added to the statute so that taxpayers, in the indicated circumstances, would be permitted to use the specified methods of accounting because it was believed that this would avoid distortions in income, for excess profits tax purposes, which would otherwise result under the methods normally used by the taxpayer in accounting for income. We submit that Congress, in seeking to prevent a distorted picture of a taxpayer's income for excess profits tax purposes, did not simultaneously intend that the limitations of the tax should be determined

in a distorted setting. In ascertaining the ultimate financial ability of corporate taxpayers to meet the burden of the tax, it would be hard to imagine why Congress would think it pertinent that profits should be measured in a manner otherwise considered to be unfair.

The taxpayer seems to assume (Br. 21, 41, 45-46) that the true measure of its profits is to be determined under the completed contract method because that is the accounting system which it uses to report income for normal income tax purposes, and because that is the method of accounting which it customarily employs. As a result, so it is argued, this is the accounting method which Congress intended to be used under Section 710 (a) (1) (B) so that not more than 80 percent of its income would be paid in taxes on income.

In ordinary circumstances, and when consistently used from year to year, it is undoubtedly true that this method of accounting will result in an accurate reflection of the taxpayer's income. The same would undoubtedly also have been true if, as it was entitled to do, the taxpayer had originally reported its income on the percentage of completion method for income tax purposes or, with the permission of the Commissioner, had even changed from one method to the other. The truth of the matter, of course, is that both accounting methods are equally valid. Normally, neither can be considered as giving a more accurate indication of corporate income than the other. It is also fairly evident that, if only one year during the life of a long term contract is isolated, neither method of accounting gives an accurate picture of the true corporate profits for neither method bears any necessary relation to the money actually received during the year under the contract or to the costs incurred. It is only the consistent use of the same method of accounting from year to year which will, in

the long run, result in an accurate accounting of income. Also, the same method must be used consistently for all purposes.

Thus, there is no "true" measure of the taxpayer's income or profits except as an accurate accounting method is used consistently for consistent purposes. When a taxpayer, for excess profits tax purposes, elects to account for its income on the percentage of completion method, the true measure of its income for these purposes requires a consistent use of the same accounting method.

It would require cogent evidence (which does not exist) to compel the conclusion that Congress intended that two different accounting methods should be used simultaneously for excess profits tax purposes. This seems manifest from the manner in which the statute otherwise would operate if the taxpayer's contentions were correct. That is, in addition to the fact that the statute imposes whichever tax is lower under Section 710 (a)(1)(A) or (B), the taxpayer seeks to have the added advantage of selecting between two accounting methods, with the result that some income may become permanently lost.

For example, it would always be true that under the completed contract method no income would be shown for the years prior to the year in which the contract is completed. During these years, accordingly, the percentage of completion method will always show more income than the completed contract method. Conversely, since the completed contract method reports all income in the year when completed, that method will always account for more income in that year than would be true under the percentage of completion method. Consequently, if the completed contract method were available under Section 710 (a)(1)(B), the taxpayer, in the years prior to the year of completion, would have

no surtax net income under that method and, consequently, no tax under Section 710 (a)(1)(B). Necessarily, in those years the tax under that section would always be less than that under Section 710 (a)(1)(A) which would require the percentage of completion method. In the year when completed, however, since the percentage of completion method would always show less income than the completed contract method, the tax, all other things being equal, would tend to be less under Section 710 (a)(1)(A). And, as must be obvious from the above, by using the completed contract method as a base in the years prior to completion, and by using the percentage of completion method in the year when the contract is completed, some income will never be reported as income for excess profits tax purposes, and some share of profits must escape the base on which the excess profits tax is levied. It is difficult to believe that Congress would have intended such a manifest absurdity.

It is also evident that taxpayers, like the present, who normally use the completed contract method would, under the taxpayer's attempted construction, be in a better position than those who consistently report their income by using the percentage of completion method. The latter, of course, would never have the choice of shifting from one accounting method to the other; during the life of each contract their system of accounting would result in all of the income being reported for excess profits tax purposes as well as for the taxes imposed by Chapter 1. Again, absent cogent evidence (which does not exist) to show that Congress so intended, the taxing statute ought not to be construed to give an advantage to taxpayers who normally use the completed contract method—an advantage which would not be available to those who normally use the percentage of completion method. Actually, since the statute

seems designed to place both kinds of taxpayers on the same basis for excess profits tax purposes, it ought to be so construed. See *Commissioner* v. *Hecht Co.,* 163 F. 2d 194 (C.A. 4th); *Commissioner* v. *Mackin Corp.,* 164 F. 2d 527 (C.A. 1st).

While the problem under the excess profits tax considered by the Supreme Court in *Commissioner* v. *South Texas Co.,* 333 U.S. 496, is different from that to be decided here, the following language we believe is also indicative that Congress did not intend the results contended for by the taxpayer here. The Court said (p. 503):

> There is no indication in any of the congressional history, however, that by passage of this law Congress contemplated that those taxpayers who elected to adopt this accounting method for their own advantage could by this means obtain a further tax advantage denied all other taxpayers, whereby they could, as to the same taxable transaction, report in part on a cash receipts basis and in part on an accrual basis.

D. *The Commissioner's Regulations are valid since they embody a reasonable construction of the statute*

We believe that the foregoing demonstrates that the statute, on its face, requires the meaning contended for by the Commissioner and applied by the Tax Court in this case, and that the legislative history and purpose of the statute cogently affirm this conclusion. We urge, however, that if there were room for construction, the Commissioner's Regulations embody a reasonable interpretation of the statute and that their validity must be upheld.

The Commissioner's Regulations, as the Supreme Court has repeatedly held, must be given proper application if they express a permissive interpretation of the statute. They may be held invalid only for the most

persuasive reasons. The latest expression of this view is in *Commissioner* v. *South Texas Co.,* 333 U.S. 496, 501, where the Court, in upholding Regulations promulgated under the excess profits tax law, said:

> This Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should be not overruled except for weighty reasons. See, *e.g., Fawcus Machine Co.* v. *United States,* 282 U.S. 375, 378.

Accord: *Commissioner* v. *Wheeler,* 324 U.S. 542.

Section 736 (b) shows that Congress expressly intended that Regulations of this nature should be promulgated for, in addition to the general statutory authority vested in the Commissioner to promulgate Regulations, that section explicity authorizes the Commissioner to prescribe such Regulations by saying that the election is "to compute, in accordance with Regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting." Also, that the "election shall be made in accordance with such regulations * * *." These clauses serve to emphasize the necessity for resolving all doubts in favor of the Regulations for, as the Supreme Court stated of similar provisions involved in *Commissioner* v. *South Texas Co., supra* (p. 503):

> This gives added reasons why interpretations of the Act and regulations under it should not be overruled by the courts unless clearly contrary to the will of Congress. See *Burnet* v. *S. & L. Bldg. Corp.* 288 U. S. 406, 415.

It is not surprising that Congress should have been so acutely conscious of the need for interpretation Reg-

ulations which would implement the statute. The reason, as the Tax Court observed (R. 160)—

> lay in the complexity of the excess profits statute, its interlocking with the income tax law, and the irrevocability of the election * * *

There were compelling circumstances, therefore, why Congress should have relied on the issuance of Regulations by the Commissioner to implement the statute, where necessary, and to provide taxpayers with as clear an understanding as possible regarding the exact details which would ensue from making the election under Section 736 (b).

All the matters previously discussed in this brief, accordingly, require the conclusion that the provisions of the Regulations in question embody a reasonable and permissive interpretation of the statute, if they do not, indeed, represent the only correct interpretation.

The taxpayer seeks to weaken the force of these Regulations as a contemporaneous administrative construction of the statute, by contending (Br. 57-60) that there has been flat disagreement with the Commissioner by (Br. 57) "officers of a co-ordinate branch of the government * * *." This assertion is based on certain cases involving proposed overassessments which had been referred to the Joint Committee on Internal Revenue Taxation and which are mentioned in paragraphs 2, 3 and 4 of the supplemental stipulation of facts. (R. 68-74.) In these cases the application of the Commissioner's position would have resulted in less tax under Section 710 (a)(1)(B) than that which would have obtained under the taxpayer's proposed construction. We need waste no time examining the details of the matters referred to in the supplemental stipulation of facts and in the taxpayer's brief, matters which the Commissioner then deemed and still considers to be immaterial and irrelevant, except to observe that the pur-

ported disagreement did not then exist, as is evident from the stipulation, and does not now exist, as is evident from the subsequent official action of the Joint Committee, referred to below.

The Chief Counsel of the Bureau of Internal Revenue, by letter dated February 11, 1949, has informed us that on April 28, 1948, Colin F. Stam, the Chief of Staff of the Joint Committee on Internal Revenue Taxation, sent letters to the General Counsel of the Treasury Department with respect to each of these cases, each letter containing the following paragraph:

> A report to me by members of the staff, based upon an examination of the opinion rendered by the Office of Chief Counsel for the Bureau of Internal Revenue and the facts as contained in the file, discloses no basis for unfavorable criticism of the overassessments. The Bureau, therefore, should proceed with the disposition of this case in whatever manner it sees fit.

The Chief Counsel of the Bureau of Internal Revenue further informs us that subsequent to the receipt of these letters the proposed overassessments were allowed and the refunds were made in each case.

Consequently, the taxpayer's attempt to establish that the Joint Committee on Internal Revenue Taxation had taken a different view of the statute than that of the Commissioner is without any foundation. Actually, the Commissioner's interpretation has been consistently followed and stands unchallenged. (R. 79-80.)[10]

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[10] The cases involving overassessments which were referred to in the supplemental stipulation are, however, pertinent in another respect since they illustrate how the Commissioner's Regulations do not operate in only one direction. While disadvantageous to the present taxpayer and others similarly situated, the Commissioner's construction of the statute will be more liberal to other taxpayers.

CONCLUSION

In view of the foregoing, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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MARCH, 1949.

APPENDIX

Internal Revenue Code:

SEC. 13 [As amended by Section 201 of the Revenue Act of 1939, c. 247, 53 Stat. 862]. TAX ON CORPORATIONS IN GENERAL.

(a) *Definitions.—For the purposes of this chapter—*

(1) *Adjusted Net Income.*—The term "adjusted net income" means the net income minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) [As amended by Section 105 (a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Normal-Tax Net Income.*—The term "normal-tax net income" means the adjusted net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b).

* * * * *

SEC. 15 [As amended by Section 105 (b) of the Revenue Act of 1942, *supra*]. SURTAX ON CORPORATIONS.

(a) *Corporation Surtax Net Income.*—For the purposes of this chapter, the term "corporation surtax net income" means the net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h). For the purposes of

this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26 (b).

* * * * *

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

(b) [As amended by Section 210 (a) of the Revenue Act of 1939, *supra*] *Cross References.*—For definition of "adjusted net income" and "normal-tax net income", see section 13.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(e) [As amended by Section 105 (d) of the Revenue Act of 1942, *supra*] *Income Subject to Excess-Profits Tax.*—In the case of any corporation subject to the tax imposed by Subchapter E of Chapter 2, an amount equal to its adjusted excess-profits net income (as defined in section 710 (b)). In the case of any corporation computing such tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), the credit shall be the amount of which the tax imposed by such subchapter is 90 per centum. For the purpose of the preceding sentence the term "tax imposed by Subchapter E of Chapter 2" means the

tax computed without regard to the limitation provided in section 710 (a)(1)(B) (the 80 per centum limitation), without regard to the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. This subsection shall not apply to any corporation exempt from such tax under section 725 or section 727.

* * * * *

SEC. 710 [As added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]. IMPOSITION OF TAX.

(a) [As amended by Section 201(a) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Section 202 of the Revenue Act of 1942, *supra*] *Imposition.*—

(1) *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 90 per centum of the adjusted excess-profits net income, or

(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter).

(b) *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income" in the case of any

taxable year means the excess profits net income (as defined in section 711) minus the sum of:

* * * * *

SEC. 711 [As added by Section 201, Second Revenue Act of 1940, *supra*]. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year except that the following adjustments shall be made:

* * * * *

SEC. 736 [As added by Section 222 (d) of the Revenue Act of 1942, *supra*]. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it

may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

(b) *Election on Long-Term Contracts.*—In the case of any taxpayer computing income from contracts the performance of which requires more than 12 months, if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of

125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, it may elect, in its return for such taxable year for the purposes of this subchapter, or in the case of a taxable year the return for which was filed prior to the date of the enactment of the Revenue Act of 1942, within 6 months after the date of the enactment of such Act, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting. Such election shall be made in accordance with such regulations and shall be irrevocable when once made and shall apply to all other contracts, past, present, or future, the performance of which required or requires more than 12 months. The net income of the taxpayer for each year prior to that with respect to which the election is made shall be adjusted for the purposes of this subchapter, including the computation of excess profits net income in each taxable year of the base period under section 711 (b), to conform to such election but for purposes of chapter 1, the tax imposed by this subchapter for any prior taxable year on account of the adjustment required by this subsection shall be considered a part of the tax imposed by this subchapter for the taxable year in which such income is, without regard to this subsection, includible in gross income. Income described in this subsection shall not be considered abnormal income under section 721.

* * * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.13-1. *Tax on Corporations in General.*— * * * The tax imposed by section 13 is computed upon the "normal-tax net income," that is, the ad-

justed net income minus the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2 and minus the credit for dividends received provided in section 26 (b), relating to dividends received from a domestic corporation which is subject to taxation under chapter 1 (85 percent of dividends received, but not in excess of 85 percent of the adjusted net income reduced by the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2). The "adjusted net income" of a corporation is the net income as defined in section 21 minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and its instrumentalities.

* * * * *

SEC. 29.15-1. *Surtax on Corporations.*— * * *

The "corporation surtax net income" of a corporation is its net income minus (1) the credit provided in section 26 (e) for income subject to the excess-profits tax imposed by subchapter E of chapter 2, (2) the credit provided in section 26 (b) for dividends received, and (3) in the case of a public utility, the credit provided in section 26 (h) for dividends paid on its preferred stock. For the purposes of determining the corporation surtax net income, dividends received on the preferred stock of a public utility must be disregarded in computing the credit provided in section 26 (b) for dividends received. Also, for such purposes, such credit is limited to 85 percent of the corporation's net income (reduced by the credit provided in section 26 (e) for income subject to the excess profits tax imposed by subchapter E of chapter 2), rather than to 85 percent of the adjusted net income so reduced. The credit provided in section 26 (a) for interest received on obligations of the United States or its instrumentalities is not allowable in computing corporation surtax net income.

* * * * *

SEC. 29.42-4. *Long-Term Contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 29.41-2.

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.736(b)-2 *Election To Report Income Upon Percentage of Completion Basis.*—If the taxpayer satisfies the eligibility requirements provided in section 736 (b) and section 35.736(b)-1 with respect to a taxable year beginning after December 31, 1939, it may elect in its excess profits tax return for such year, or if the election is made for a taxable year the excess profits tax return for which was filed prior to October 21, 1942 (the date of enactment of the Revenue Act of 1942), it may elect not later than April 21, 1943 (six months after the date of enactment of the Revenue Act of 1942), to compute its income from long-term contracts upon the percentage of completion method of accounting under the provisions of section 29.42-4 (a) of Regulations 111 or section 19.42-4(a) of Regulations 103 applicable to the taxable year for which the tax is being computed. An election made by the taxpayer pursuant to the provisions of section 30.736(b)(2) of Regulations 109 shall be deemed to be made pursuant to the provisions of this section.

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SEC. 35.736(b)-3 [Amended by T. D. 5388, 1944 Cum. Bull. 387] *Computation of Net Income Upon Percentage of Completion Method of Accounting.* —(a) *Excess profits tax taxable year.*—If a taxpayer has elected under section 736 (b) and section 35.736(b)-2 to compute for excess profits tax purposes its net income from long-term contracts upon the percentage of completion method of accounting, in lieu of the completed contract basis, gross income from such long-term contracts shall be reported for each excess profits tax taxable year upon the basis of percentage of completion of such contract in such year. There shall be deducted from such gross income for a taxable year all expenditures made during such year on account of the contract, account being taken of the material

and supplies on hand at the beginning and end of the taxable year for use in connection with the work under the contract but not yet so applied. Any deductions under section 23 which are limited to a percentage of net income (computed without regard to such deduction, as for example, the deduction for charitable contributions which is allowed by section 23 (q)) shall, for excess profits tax purposes, be determined upon the basis of such net income with the income from long-term contracts computed upon the percentage of completion method of accounting, and not upon the basis of net income for Chapter 1 purposes. No reserve for bad debts arising from accounts receivable from long-term contracts may be set up for excess profits tax purposes unless a reserve has been established for income tax purposes.

In computing the net operating loss deduction for the purposes of the excess profits tax for a taxable year pursuant to section 23 (s), section 122, and section 711 (a)(1)(J) or section 711 (a)(2)(L), the net operating loss under section 122 (a) and the net income under section 122 (b) for any taxable year prior or subsequent to the taxable year in which the election under section 736 (b) and section 35.736(b)-2 is made shall be determined by computing income from long-term contracts upon the percentage of completion method of accounting. The excess profits net income for the taxable year for which the net operating loss deduction is computed shall, for the purposes of the reduction provided by section 711 (a)(1)(J)(ii) or section 711 (a)(2)(L)(ii), be determined by computing income from long-term contracts upon the percentage of completion method of accounting.

In computing normal tax net income for the purposes of determining excess profits net income, the credit for dividends received shall be limited to 85 percent of the adjusted net income computed by determining income from long-term contracts upon the percentage of completion method of accounting as provided in section 736 (b) and this section, in-

stead of upon the completed contract basis.

The excess profits tax may be computed under section 710(a)(1)(B) as an amount which when added to the normal tax and surtax computed under Chapter 1 for the taxable year equals 80 percent of the corporation surtax net income properly adjusted under the provisions of section 710 (a)(1)(B) applicable to such year. For such purpose, the corporation surtax net income shall be determined by computing the income from long-term contracts upon the percentage of completion method of accounting. The credit for dividends received used in computing corporation surtax net income shall be limited to 85 percent of the net income determined by computing income from long-term contracts upon the percentage of completion method of accounting, and the normal tax and surtax shall be the actual normal tax and surtax determined under Chapter 1.

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